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The Economic Outlook: Global and Domestic Challenges to Growth[1]

Good afternoon. It is a pleasure to be with you today. You know, I'm a big Giants fan, and I'm thrilled to visit Tim Lincecum's hometown. Now, Timmy is having a tough start this season. But I have great faith in his ability to bounce back. The subject of my talk is another story about getting back on track—but this one concerns our nation's economy. We are now nearly three years into a recovery from a very severe recession. We've made up a lot of ground. But the aftereffects of that terrible downturn are still with us, particularly an unacceptably high unemployment rate.

This afternoon, I'll offer my economic outlook for the period ahead. I'll describe some looming threats that could cause growth to fall short of my expectations, most notably the drama playing out in Europe. I'll close with my thoughts about Federal Reserve policy. I should note that my remarks represent my own views and not those of others in the Federal Reserve System.

As I noted, our economy has been expanding for nearly three years now. But the pace of growth has been considerably less robust than in the typical post-World War II recovery. And the gains have been halting. Sometimes the economy seems to build up a head of steam. At other times, the momentum flags. This sputtering progress reflects a constellation of forces that

[1] I want to thank John Fernald, Mark Spiegel, and Sam Zuckerman for their assistance in preparing these remarks.

has weighed on economic performance, including the most traumatic housing crash since the Great Depression, tight credit, and widespread uncertainty.[2]

Despite these obstacles, the nation has been adding jobs, consumer sentiment has improved over the past year, and household spending has been on the rise. Credit is still tight, but it's easier to borrow than it used to be. For those who can get credit, borrowing costs are exceptionally low, thanks in part to the Fed's low-interest-rate policies.

Overall, consumer and business demand pent up during the downturn is slowly reviving. Take motor vehicles. Car sales plummeted during the recession and people made do with what they had in the garage. In 2011, the average age of motor vehicles on the road reached a record 10.8 years. But people get tired of driving old, worn-out cars. With the economy improving and auto financing rates at rock bottom, it's not surprising that traffic in auto showrooms has been brisk. Motor vehicle sales over the first five months of this year are up more than 12 percent over the same period last year.

Similarly, businesses have been carrying out some of the capital investment postponed during the downturn, especially in the information technology area. Over the past year, business investment on equipment and software rose over 8 percent, adjusted for inflation.

We're even seeing glimmerings of good news on the housing front. To be sure, we've been fooled by false dawns in housing before. Nonetheless, a number of indicators suggest that we've started to claw our way off the bottom. Nationally, house prices no longer appear to be falling. And there are signs that inventories of unsold homes are coming down. There's still an enormous backlog of foreclosed properties. However, anecdotal reports suggest that those

[2] See Williams (2012a) for a discussion of the financial roots of the crisis and how they have affected the pace of recovery.

properties have been pretty well picked over, encouraging builders to break new ground. As a result, home building is finally rising, though it's still at extraordinarily low levels.

All these are the good signs for our economy. But some others aren't so encouraging. Two major developments have been holding back growth, and they threaten to derail the recovery in the future. The first is the budget squeeze at all levels of government. Federal spending rose in response to the downturn, but that's been unwinding. At the same time, state and local governments have been implementing austerity programs as they seek to close budget gaps. Since the recovery began, states and local government payrolls have fallen by about half a million workers.

The fiscal burden on the economy could turn significantly worse at the end of this year, when federal spending cuts and tax increases are scheduled to kick in. Unless Congress acts, numerous significant tax reductions will expire next year. In addition, large spending cuts will take place automatically under the sequestration procedure agreed to by Congress and the White House. A recent Congressional Budget Office report suggested that scheduled cuts in spending and increases in taxes could knock around 4 percentage points off economic growth in 2013.

Fortunately, I don't think that will happen. I expect an agreement will be reached that will forestall such a sudden massive swing to fiscal contraction. Still, federal fiscal policy is moving toward greater belt tightening, and that will put a significant drag on economic growth next year. Moreover, the uncertainty surrounding the federal budget appears already to be taking a toll on business and consumer confidence.

The second development restraining the U.S. economy is the European sovereign debt crisis. Needless to say, Europe's prospects are vitally important to the United States. Our economy is closely tied to Europe on a number of levels. First, the countries of the European

Union take close to a fifth of our total exports. Second, our financial systems are bound tightly together. Developments in European financial markets spread to our markets as well.

To some extent, this is already happening. Europe's economic slowdown is limiting demand for our exports. As worries about Europe have escalated, investors across the globe have flocked to the safety of high-quality investments, such as U.S. Treasury securities. This has pushed Treasury yields down to levels not seen since the 1940s. On their own, lower Treasury rates help U.S. economic growth. However, other spillovers from Europe are offsetting these benefits. The flow of money to the United States has boosted the value of the dollar, which makes our goods and services more expensive overseas. The European crisis has also prompted investors to avoid risky assets more generally, including U.S. stocks and corporate bonds.[3] Lower stock prices and higher credit costs weigh on both the willingness and the wherewithal of American consumers and businesses to spend.

Amid these crosscurrents, we've managed to maintain a moderate pace of economic growth, including job gains of about 150,000 per month over the past year. I'm sure you noticed the disappointing employment report for May. However, in looking at the economy, it's important not to get carried away by one month's data. We saw very good jobs numbers early this year, and some commentators rushed to declare that the economy was taking off. More recently, we've seen weak numbers, which has prompted commentary that the economy has stalled. The fact is, these data fluctuate from month to month. Even the weather can cause big swings in job growth. In thinking about where the economy is headed, we should focus on underlying trends and not get caught up in short-term gyrations. In that regard, the underlying

[3] Hale, Marks, and Nechio (2012) show that U.S. corporate bond spreads tend to rise as a result of negative shocks in Europe.

trend in job growth is probably closer to the 150,000 monthly job gain number that we've seen over the past year than to the recent weaker data.

Adding jobs at such a pace should bring the unemployment rate down slowly and steadily. Surprisingly though, the unemployment rate has fallen much faster over the past year than one would expect, given the moderate pace of job gains. Just in the past nine months, the unemployment rate has declined nearly a percentage point. If it were to continue to drop at this pace, it would reach 5½ percent by the summer of 2014. That would put it close to its normal, long-term trend level.

In fact, I don't expect the unemployment rate to keep dropping that fast. It's more likely to come down much more gradually over the next few years. To understand why, we have to look at how the unemployment rate is measured. Each month, households are surveyed about whether family members were working and, if not, whether they were actively looking for a job. If they weren't looking, they aren't considered part of the labor force. So, if an unemployed person stops looking for work, then the official count of the unemployed drops by one. Clearly, such a decline doesn't represent a real improvement in the labor market. It's just the opposite.

And there's the key to a significant part of the decline in the unemployment rate over the past year or so. Lots of people have simply stopped looking for work and left the labor force. Officially, they are no longer counted as unemployed, even if they want a job. In thinking about what's going to happen to the unemployment rate over the next few years, a critical question is whether these people will rejoin the labor force when jobs become available. We can get a clue by examining more closely just who has been dropping out of the labor force.

To do that, it helps to look at the labor force participation rate, which is the percentage of adults in the labor force. Since the start of the recession, the participation rate has dropped from

66 percent to a little under 64 percent, a substantial fall of about 2 percentage points. About half of this decline reflects long-running demographic trends.[4] For example, there is an ongoing process of lower labor force participation as the baby boom generation reaches retirement age. Most of these boomers are unlikely to reenter the labor force.

However, the other half of the falling labor force participation rate reflects a large exodus of young people and adults of prime working age. Many of the prime-age workers who have left the labor force report that they want jobs and are available to work. They just aren't actively looking for a job, so they're not counted as unemployed. Most of these people will probably return to the labor force as things get better. Indeed, many of them have already done so. Overall labor force participation has leveled off over the past several months, and participation among prime-age males appears to have picked up.

As these workers come back into the labor force, I expect the unemployment rate to fall more slowly than it has over the past year. In a sense, this is just arithmetic. Some new jobs will be filled by people reentering the workforce who weren't previously counted as unemployed. Thus, as workers reenter the labor force, the unemployment rate is going to come down more gradually—even if we create jobs at the past year's pace.

Putting it all together, my forecast calls for real gross domestic product to expand at a moderate pace of about 2¼ percent this year and about 2½ percent next year. I expect the unemployment rate to remain at or a bit above 8 percent for the remainder of this year, and then gradually decline to a little above 7 percent by the end of 2014.

However, the uncertainty around this forecast is great. I mentioned the looming threat of automatic large tax increases and cuts in spending at the start of next year. And the ongoing European crisis represents another wild card for the U.S. economy. It's impossible to predict

[4] Aaronson, Davis, and Hu (2012). The authors examine participation trends since 1999.

with any certainty how the situation in Europe will play out. My forecast assumes that Europe's distressed pattern of the past two years will continue. The severe austerity measures implemented in many European countries have choked off economic growth. And that makes it harder to trim government deficits. Recurrent spikes in fear and uncertainty are followed by piecemeal actions that buy time. What hasn't emerged is a credible, comprehensive solution to Europe's problems.

Not surprisingly, the approach Europe has taken so far hasn't worked well. We've seen this in Greece, where each effort to contain the crisis has unraveled. Now, fears that Greece could go through a disorderly default and drop the euro are again capturing headlines. These worries have caused people to pull their investments and bank deposits out of Greece, which makes things worse.

The crisis has also flared up in Spain, illustrating the need for a much more comprehensive, pan-European approach. The Spanish banking system needs to be recapitalized on a large scale. Failure to do so would undermine confidence in the banking system, and that could lead to a run on the banks. Spain would then find itself in a massive credit crunch, further damaging the economy. But recapitalization isn't easy. The Spanish government faces high borrowing costs because investors worry that Spain could go the way of Greece. So it's difficult to raise the funds for recapitalization.

It's a chicken-and-egg problem. If the government can make a convincing case that it will do what's necessary to back the banking system while meeting its own debt obligations, things can work out. But, if doubts arise, then the government's borrowing costs could skyrocket, making it impossible to meet its goals. Without a viable backstop from its European partners, the fear of such an outcome could become a self-fulfilling prophecy.

As we learned from the financial crisis of 2007–09, events can spin out of control once panic takes over. A development that on its own might not be disastrous, such as another Greek default or even its abandonment of the euro, could set off contagion that would undermine confidence in other countries. The effects could overwhelm private credit markets in Europe, causing a financial meltdown comparable to what we saw here during the financial crisis. Needless to say, if that were to happen, the U.S. economy would be harmed on a number of levels. Our trade with Europe would suffer greatly. And our financial markets would be severely strained.

On that somber note, let me turn to monetary policy. I'll start by citing the dual mandate Congress has assigned the Fed: achieving maximum employment and price stability.[5] In terms of maximum employment, it's safe to say that most people would view the current 8.2 percent unemployment rate as far too high. I completely agree. But, is 7 percent too high? What about 6 percent? Why shouldn't we aim for 0 percent?

Economists have given this question a great deal of thought. By maximum employment, we mean the highest level that can be sustained without pushing inflation up. So, how far are we now from that holy grail of maximum employment? This is where things get complicated. Maximum employment is not a fixed number. It's a moving target, depending on how efficient the labor market is at matching workers with jobs. For example, if people have to move or learn new skills because of structural shifts in the economy, they may not be ready for the jobs that are out there. We may need lots of nurses, but not many construction workers now.

At the Fed, we use the unemployment rate as an important yardstick for determining how far we are from maximum employment. Here I want to introduce the concept of the natural rate

[5] The Federal Reserve Act also calls for moderate long-term interest rates. See Williams (2012a) for a discussion of the Federal Reserve's dual mandate.

of unemployment. Essentially, it's a way of expressing this concept of maximum employment in terms of the unemployment rate. In other words, the natural rate of unemployment is the equilibrium rate that pushes inflation neither up nor down.

The labor market disruptions I just mentioned have made the market less efficient, which raises the natural, noninflationary rate of unemployment. I estimate that this natural rate was about 5 percent before the recession, but is currently around 6¼ percent.[6] In May, the unemployment rate was 8.2 percent, about 2 percentage points above my estimate of the natural rate. So, by this measure, we are very far from our maximum employment mandate. And, as I mentioned earlier, I expect the unemployment rate to be above 7 percent until late 2014. I don't expect we'll be at maximum employment until 2016.

The second part of the Fed's dual mandate is price stability. Earlier this year, the Fed's policymaking committee, the FOMC, stated that a 2 percent inflation rate was most consistent with maximum employment and price stability, and we set that rate as our target. Over the past year, prices rose 1.8 percent, according to the Fed's preferred measure of inflation. I expect inflation to come in below the 2 percent target both this year and in 2013. The main reason is a weak job market, which has kept labor compensation costs contained. We've also seen substantial declines in oil and other commodity prices recently as concerns about global economic growth have intensified.

In sum, I see the Fed falling short on both our maximum employment and inflation mandates for some time. And the turmoil in Europe and government fiscal retrenchment in the United States raise the danger that the economy could perform worse than I expect. For these reasons, it's crucial that we maintain our current highly stimulatory monetary policy stance. As

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[6] See Daly et al. (2011) and Williams (2012b).

part of this, we've stated our intention to keep our benchmark short-term interest rate at exceptionally low levels at least through late 2014.

We must also stand ready to do even more if needed to best achieve our statutory goals of maximum employment and price stability. The April FOMC statement indicated that the "Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in a context of price stability."

If the outlook for growth worsens to the point that we no longer expect to make sustained progress on bringing the unemployment rate down to levels consistent with our dual mandate, or if the medium-term outlook for inflation falls significantly below our 2 percent target, then additional monetary accommodation would be warranted. In such circumstances, an effective tool would be further purchases of longer-maturity securities, potentially including agency mortgage-backed securities. Past purchases have succeeded in lowering borrowing costs and improving financial conditions, thereby supporting economic recovery.

As I've tried to make clear, these are highly uncertain times, and our crystal balls are much cloudier than usual. At the Fed, we must be vigilant, and ready to adjust monetary policy as circumstances warrant. Thank you very much.

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